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Interest and Exchange Rates and Reparation Payments

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IT is not easy to distinguish effects from causes. Most effects become, in turn, causes, and most causes are themselves the effects of antecedent causes. In the economic field, current discussion is much interested in exchange rates and interest rates, both of which it treats as causes, although both are primarily effects.

First, a few words as to interest rates: Booms and depressions are caused by hope of higher and fear of lower prices, whether of commodities or of securities. The hope of higher prices leads to a demand for funds for the purpose of purchasing in anticipation of a rise; the fear of lower prices leads to repayments of loans with the proceeds of sale in anticipation of a fall of prices. The rate of interest rises or falls as an effect of the borrowing or the repayment. No rate, however low, will tempt borrowing for the purpose of purchasing a commodity whose price is believed too high, and, broadly speaking, no rate, however high, will, by reason merely of its being high, restrain borrowing intended for the purchase of commodities which are believed certain to rise. A high interest rate will very often deter borrowers, because it is taken as a warning that commodity prices are regarded as too high or that money may become unobtainable at any price. It will serve as a concrete expression of opinion by those best qualified to judge as to the reasonableness of the general level of prices.

REVIEW OF BUSINESS CONDITIONS

Since April 6, 1917, we have passed through almost every phase of business

conditions; a rapid review of that period will emphasize the above contentions. War finance necessarily involved inflation. It was impossible to check private consumption ratably as government consumption increased, and correspondingly to increase savings as government expenditure increased. So, until price controls became effective, prices rose, and at all times a large part of the government's financial needs had to be met through the creation of credit by the member banks of the Federal Reserve System. During this period, therefore, market rates of interest were fixed by the Federal Reserve Banks, being the rates they charged for the manufactured credit: the use of the credit thus created was carefully safeguarded through Capital Issues Committees, the War Industries Board, the Food Administration, and kindred bodies. Subtracting from the government needs, the savings of the people, we get the amount of inevitable inflation: no rate of interest, however high, would have either diminished the government's requirements dictated by war needs, or increased the savings of the people, whose consumption (which is the complement of their savings) was regulated by the governmental bodies named above and by their own patriotism.

During the post-Armistice period, with the controls on prices and on consumption removed, new conditions developed. There was a recognized, a notorious shortage of commodities; prices soared; neutral countries that had here accumulated huge balances, which during the War we had not

permitted them to employ in the purchase of commodities, used those balances to buy commodities they sorely needed; our own people, in receipt of high wages, competed with the neutrals while at the same time our allies and their nationals strained their resources to supply in our market their own unquestioned needs. This competitive buying sent prices soaring. Anyone that could lay his hands on commodities was sure of a prompt profit; manufacturers competed with each other for raw material and for labor regardless of cost, for they were sure of a prompt sale and had but to add to their selling price all elements of cost, plus a large profit. Under these circumstances, cost of interest, like every other element of cost, was added to price, and, just as no rate of wages or price for material checked production, so no rate of interest, however high, could have checked borrowing. What finally checked the upward price movement was, in part, the export of gold, containing, as it did, the menace of a total failure of loanable funds, and the discovery in certain lines of commodities that shortage had been turned into surplus. The fact that the raising of Federal Reserve rates was roughly coincident with the peak of expansion arose, in part, from the fact that the raising of the rate was largely brought about by the export of gold, the two effects—higher interest rates and the check to borrowing—being thus twin effects of the same cause, i. e., the export of gold; and in part, from the moral effect of such a raise of rate.

Real deflation began when once it was realized that through panicky duplication of orders and through hoarding by speculators, dealers and consumers, commodity shortages had been converted into surplus. Then came swift cessation of buying, and

lack of confidence. It was now clear that invisible supplies had been huge during the time visibles were nil; now visibles became huge, while invisibles actually shrank to the negligible. During such a period, no reduction of interest rate, however great, will induce borrowing for the purpose of buying falling commodities.

PRICES AND INTEREST RATES

During a war-period, with its inevitable artificial conditions, the rediscount rate determines the market rate. At other times, it appears that the trend of prices determines the demand and hence the market for money. Except, therefore, in its rôle of prophet, it seems clear that the money market is dominated by the trend of prices and that the rediscount rate must follow and not attempt to fix the rate for the money market. Price is the instrument by which consumption and production are brought into balance. Overproduction of desirable commodities should be an impossibility; a progressively enlarging standard of living should absorb all we can produce; what defeats the fulfillment of this desirable end are the same human qualities that render any production possible, viz.: the unbridled desire for gain, taking sometimes the form of headlong production of things not needed, and sometimes the form of strikes against needed wage reductions. These things lead to maladjustment of production. Price declines lead to unemployment, unless promptly countered by wage adjustment; hoarding ultimately leads to price declines; unwise capital expenditures lead to price declines when the failure of enterprises brings about unemployment and consequent reduction of consumption. Through this maze of intricacies we must depend on price fluctuations to adjust

production to consumption, and vice versa, and the trend of those fluctuations is the impelling force that controls the demand for funds. In normal times during a period of rising prices the rediscount rate, if lower than or too near to the market, becomes an impelling cause of inflation. During a period of falling prices, the rediscount rate, if too much above the market, becomes an impelling cause of too rapid deflation; if below the market, it is without effect. These generalizations do not apply to war conditions.

EXCHANGE RATES

Exchange rates, also, are primarily effects. Exchange rates are an indication of the state of balance or unbalance of international payments. Unbalanced payments make themselves felt through the exchange rates, and it is these rates which, in turn, become the proximate causes, or more properly, the medium through which are brought into existence the unsettlements and hardships resulting from this unbalanced state. The hand or the brain and not the lever is the cause that shifts the gears. Unbalanced payments acting on exchange rates so move them that, like the governor of an engine, they tend automatically to correct the state of affairs that throws them out of balance. Attempts to normalize rates merely result in delaying the correction of the cause and the various devices to stabilize exchange which ingenious minds busy themselves in contriving, are merely conscious or unwitting efforts to avoid the unpleasant effects caused by unbalanced budgets and unbalanced foreign trade; they are simply efforts to evade disastrous effects, instead of constructive steps along the much more difficult and unpopular path of curing the causes, viz.: unbalanced budgets and unbalanced trade. Every plan for stabil-

izing exchange has concealed in it somewhere an application for unlimited foreign advances in favor of the country whose exchange is to be stabilized. Every such plan implies running in debt and consequently implies also a lender. A falling (not a fallen) exchange does through the market act as a stimulus to exports; it is the automatic effort to right the balance by checking imports and stimulating exports.

ECONOMIC EFFECTS OF REPARATION PAYMENTS

These disconnected commonplaces lead up to another commonplace—that is, that payment of reparations beyond certain limits must of necessity entail disastrous economic consequences to other countries. It is a distasteful conclusion that reparation for brutal and unjust aggression cannot be exacted without damage to the innocent victim of the aggression and to the innocent bystander, but we gain nothing by failure to face the facts. When the facts are established, the course of action can be dictated either by the desire to impose retribution on the aggressor, or by a regard for the future economic welfare of the aggrieved, but having faced the facts, the conclusion, whatever it is, will at least be the result of intelligent contemplation of probable consequences. It must not be forgotten that for the deepest injuries there can never be adequate reparation; all that is humanly possible, and all that municipal law, with due regard for dealing only with realities, attempts to attain, is punishment of the offender and money damage to the victim. Life and limb cannot be restored, youth cannot be renewed, past sufferings and anguish cannot be obliterated.

Undoubtedly, there is a certain measure of reparation that can safely

be exacted: this will be found along the line of the restoration of devastated areas, the replacement of destroyed facilities and, in a measure, the improvement of existing facilities. Such reparation must be largely of such a nature as not to interfere with pre-war normal activities. The transfer of foreign investments offers further opportunities to collect reparation and so, perhaps, does the taking over of productive domestic establishments of the aggressor. But beyond these and other limited categories the broad condition underlying reparation payments is this: that the payer must work hard and live frugally. To work hard and to dispose of the product of his labor implies large exports by the payer and frugal living implies restricted imports. Reparation payments, therefore, mean strong competition by German goods in domestic and neutral markets and limited markets in Germany for foreign goods. These tendencies work themselves out through the exchange rates which appear as the proximate causes, but to discuss exchange rates as the cause of commercial handicaps can lead only to tinkering with the barometer in the hope of affecting the weather.

There is nothing difficult in these conclusions. They have at all times been clear and they have probably been at all times recognized by the British and the French. It is not strange that they were not adopted as bases of action. The Allies, especially the French, were still too vividly under the impression of brutality and outrage to give full sway to reason. These people had seen and lived through things which to us were only tales. Tennyson rightly says in *Enoch Arden*:

“Things seen are mightier than things heard”

and it was perhaps too much to expect the danger of comparatively remote economic consequences to dissipate the “red mist of anger.” Besides, the political life of ministries depended on their ability to exact reparation, or at least to claim that they had exacted it. It looked then as though many successive ministries must fall before realities would be faced; it looked as though every critic in the ranks of the opposition must have his turn of power and must learn by experiment his inability to reverse the laws of nature before one could be found with sufficient backing to face the facts. The Reparations Commission was accordingly endowed with sufficiently broad powers to mitigate to the victors the disastrous consequences of unwise exactions.

Similar consequences will always follow analogous causes; the repayment to the United States of our governmental advances to the Allies will involve unbalanced international payments, not unlike reparation payments, and when the time comes that Britain and France and Italy are prepared to pay interest on and to begin repayment of their indebtedness to America, we shall witness the same dislocation of industry of which we are now, as a result of reparation payments, beginning to feel the effects. And there will then be the same delay in diagnosing the trouble; the consequences will not be foreseen and averted; it will require a present pain before we search for the causes. As in reparations, so there will then be limited ways in which we can receive payment without damage, such as the transfer to us of foreign investments, but we must recognize that there are limits beyond which such payments cannot go without entailing mischief. Any such transfer of foreign securities would not, of course, be by governmental action;

it would be effected through private transactions brought about by exchange rates and security prices, and through them made possible and profitable. We are not now receiving either interest or principal on those debts and they are not, therefore, now upsetting our equilibrium, but the time is likely to come when they will plague us and then, as now, public discussion will undoubtedly center on the exchange rates.

CONJECTURES AS TO GERMAN POLICY

In the effort to understand what is going on, it is perhaps interesting to put to ourselves the problems of those responsible for German economic policies and to try the formulation of solutions as though the burden of dealing with them lay upon us.

The main aim of German ministers must be to keep the population employed and fed; failure to do either will cause the ruin of the country and incidentally the fall of the ministers. From their point of view, other problems can well wait. To accomplish these aims and to keep the Allies at least partly satisfied with reparation payments, requires the import of raw materials and foodstuffs, and the export of commodities in order to create foreign balances. The key to these three purposes is to be found in one of them, viz., a large volume of exports. It is even conceivable that the German government may, in effect, be causing its manufacturers and merchants to sell their commodities abroad at every opportunity and irrespective of the price, while the government, either directly or indirectly through subsidizing the cost of living, or otherwise, pays to the exporters in marks whatever amount of marks is necessary to reimburse them for the cost plus a profit. To do this, it is true that the printing press must be kept running, but, in its larger as-

pects, is that of itself really fatal? It is admitted to be undesirable, but is it fatal? What would such a policy accomplish? It would furnish foreign balances for the import of food and raw material, and it would keep German industry fully employed. If by such a policy the demand for reparation can at the same time be satisfied sufficiently to ward off foreign occupation, it will mean that in the process there will be established a surplus of exports sufficient to keep Germany employed and fed, and to prevent foreign complications. And we may be sure that German ministers do not overlook the incidental demonstration of what reparation payments may mean to foreign industry.

So much for the problems with which they have undertaken to cope—what of those they will have created in the process? They will have inflated their currency almost to the point of extinction, but is not that a problem with which they can afford to deal later? If foreign payments and receipts can thus be put in balance the mark will on some level, however low, cease to decline, and ministers can then, having reached stability, undertake to deal with the problems arising out of currency inflation, whether by the establishment of a new standard coin of the gold value of the old mark and the declaration of its value as equivalent to 100 or 200 of the old marks, or by some other form of what is euphemistically called devaluation. If necessary, they can go further and fund the interest on their domestic debt for five or ten years, agreeing gradually to resume interest on a rising scale and, having accustomed the world to this, they can, if it prove necessary, repeat the process at the end of the moratorium. That such steps would involve great hardships to certain sections of the community;

that the old investor class would be completely ruined; that a new class of captains of industry would spring up,—might be deplored by ministers, but would undoubtedly be disregarded. The effect of such a policy of cruel injustice, which knocks the prop of confidence from under the financial structure, would long make itself felt in recklessness of expenditure and lack of effort at capital accumulation; whether the need is sufficiently desperate to justify the sacrifice must be decided by those charged with the responsibility. The life of the nation must be their aim rather than the welfare of any particular class.

“Are God and Nature then at strife,
That Nature sends such evil dreams
So careful of the type she seems
So careless of the single Life.”

However callous Germany's brutality may have made us to her fate, we cannot but recognize that the preservation of her national life is for her own statesmen a legitimate aim.

These are mere conjectures as to German policy. They suggest, however, a wider query, disconnected from our immediate problems. Is a balance of commodity imports the unqualified blessing it is represented to be? Is the position of creditor nation necessarily an advantage? This requires us to fix, at any rate for the purpose of the discussion, the economic aims of statesmanship; and that attempt discloses the fact, obvious enough when stated, that the welfare of all sections of the community is not necessarily served by the same measures. A creditor country with large foreign investments, like England, receives its foreign income for the benefit of its investing classes, who take it in the form of food, clothing and other elements of maintenance for themselves and their personal dependents,

servants and those employed in ministering to their wants. This foreign income furnishes but limited employment for productive labor at home. May not the admittedly low pre-war standard of living of British labor be the result of England's position as a creditor nation? If there be any basis for these suggestions, it would be useful to inquire in what manner and to what extent these undesirable consequences can be overcome. The gradual raising of the average standard of living could perhaps reconcile full employment and an import balance of commodities.

In our case, the repayment to our government of its advances to the Allies will undoubtedly reduce the taxes of those that pay taxes, but it may at the same time, through the stimulation of importation, throw the worker out of employment. May not the instinct of the crowd and the conclusions of the economists of a previous generation who rejoiced at what we still call a “favorable” balance of trade (though we are careful always to enclose that term in quotation marks), have been sounder than what are regarded as the more enlightened conclusions of a later day? These observations on the social consequences involved in the international balance of payments are unmaturing reflections which can be adequately dealt with only by trained statisticians and economists.

THE HEALING OF TIME

Looking at the present situation broadly, what is taking place? It is admitted that there is noticeable improvement in conditions abroad. Great Britain, France, Italy, Belgium and Czechoslovakia give evidence of marked betterment and even Austria shows some signs of revival. There are indications in Russia of a recognition

of the conditions needed to secure production. What is bringing about these changes? Is it the action of governments? Is it international assistance? Or is it, rather, the healing action of time, working through individual initiative—the effort of each man to improve his own position. We grow impatient that over three years have passed since the Armistice and that conditions are still unsettled, boundaries in some cases not definitely fixed and devastation not fully repaired. Are we not losing our sense of perspective when we indulge in these feelings? School histories will pass over ten years in a single line of narrative and, in so doing, are but giving proper recognition to the time units in which national affairs must be measured. And the War was in its nature more cosmic than national. The effects of such an upheaval cannot be brought to a stop except gradually.

We can reason out what should be done to mitigate the consequences of war and to hasten the restoration of normal conditions but we cannot make our conclusions effective except through man acting in his political capacity and man, politically, is not a rational animal. Politically, man tries every unsound device first, and, after repeated failure, reluctantly adopts the effective course and then triumphantly proclaims that the people are always right—in the long run. And so they are—but only because they have the vitality to outlive all their mistakes.

“Men die, but Man lives.”

Inefficiency is the price we pay for liberty and it is not too high a price. We can expect sound conclusions to emerge only from experiment and failure.

The various economic conferences we have witnessed are the response to the feeling that something should

be done: the only effective work, however, is being done by time.

Had the indebtedness of the European governments to the United States government been cancelled three years ago and had larger governmental advances been made by us, we should but have impeded the recovery by diminishing the incentive to individual effort.

Budgets must be reduced everywhere, not least by our own government. Expenditures for armament must be reduced. Peace will come only as the desire to aggress vanishes and as each nation realizes that its neighbor has no designs against its security (if in fact there be no such designs); and to this end nations must get to know one another better.

Peace will not come by treaties; treaties can be broken: it will come only by the effective desire for peace. The great good of the Washington Conference¹ lies in the conviction that it carries of pacific intention, rather than in the formulae that it adopted.

CANCELLATION

As to the cancellation of European indebtedness to our government, undoubtedly it should be done—some day. It cannot be done conditionally: we cannot lay down the conditions of cancellation and then undertake to judge whether or not the conditions have been fulfilled. That would lead to suspicion, recrimination and ill will. But when conditions shall have become right, we can actually cancel our claims. In the meantime, debts that are not being paid impose no burden and while we are awaiting the ripening of events, our people will have an opportunity to try out some of the preliminary errors which politically it seems necessary to test by experience.

¹ Conference on the Limitation of Armament, Washington, D. C., November 11, 1921.

The time for cancellation will come when Europe is about ready, through the continuation of the great efforts required during reconstruction, to begin repayment and it will then hardly be profitable to debate whether we are cancelling our claims because Europe, with due regard to the standard of living of her people, cannot afford to pay, or because we, with due regard to the full employment of our workers, cannot afford to collect, because, for one thing, we shall be acting for both reasons: the same conditions that will

then make it possible for Europe to begin repayments, viz.: her ability to export a surplus of commodities, will make it inadvisable for us to receive payment, which will be actually made in the form of commodities.

All this is in the future. In the meantime, through discussion and still more through experience, we are preparing ourselves for the day when a decision will be required and time is doing the real work. Exchange rates are barely the ripples on the surface.

America's Coöperation Indispensable to International Security

BY PIERPONT B. NOYES¹

President Oneida Community, Limited, American Commissioner on the Inter-Allied Rhineland Commission, 1919-20.

I AM bound to confess that I feel only an academic interest in the discussion of plans for the economic rehabilitation of Europe. I cannot believe that economic schemes, even the most practical, will produce any considerable results until certain vital political problems have been solved. A necessary basis for economic activity is and always has been political security, just as civilization itself awaited the attainment of personal security. Until men had established a modicum of immunity from attack by their fellowmen, our primitive ancestors stayed in their caves or stole out furtively on expeditions for food. Life was wholly individualistic and even the beginnings of social and material progress were impossible. In the same way, industry, trade and finance thrive only in an atmosphere of national security. There is a surprising parallelism be-

tween the relative industrial development of the different countries and the relative security each has enjoyed, whether the latter has resulted from accidental geographical considerations or from racial temperament.

The European political system has never and can never give permanent security. Continental Europe throughout its history has enjoyed only little patches of security, always underlain by plans for the next war. The continental political system is the result of evolution during centuries when men valued political power much more than they did economics, and the habits and traditions of European militaristic diplomacy have become too fixed to be changed without pressure from the outside.

Under this European system rulers and statesmen build military alliances ever stronger, one nation against another, while the ordinary citizen is cajoled into patriotic assent—the am-

¹ Author of *While Europe Waits for Peace*, Macmillan, 1921.